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2007 FEB -1 P 4: 36

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E-01933-05-0650

Mr. James Pignatelli
President and CEO
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Arizona Corporation Commission
DOCKETED

FEB -1 2007

Mr. Raymond S. Heyman
Senior Vice President and General Counsel
UniSource Energy Corporation
One South Church Avenue, Mail Stop UE181
Tucson, Arizona 85701-0001

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Re: Mr. Pignatelli's letter to Commissioner Kristin K. Mayes dated January 26, 2007

Dear Mr. Pignatelli and Mr. Heyman:

I have reviewed Mr. Pignatelli's letter to Commissioner Kristin K. Mayes dated January 26, 2007. Upon my review of that letter, I have determined that it is necessary for me to provide a response in my capacity as the Commission's Chief Counsel.

Most of the points that must be made in response to Mr. Pignatelli's letter are contained in the letter I submitted by way of response to Mr. Heyman's letter to Commissioners dated January 22, 2007. Despite the fact that many of the same points that responded to Mr. Heyman are applicable in response to Mr. Pignatelli's letter, there are several that deserve particular emphasis. This is particularly true since both of you appear to view the 1999 Settlement Agreement as somehow separate and apart from the regulatory proceeding that TEP has brought seeking to amend that Settlement.

In any event, there are a few points that must be understood by your Company. First, please be advised that even though the Settlement contains a provision which indicates that the Commission becomes a Party to the Settlement as a result of issuing an Order approving it, I do not agree with the assertion that the Commission is a Party to the Settlement in the manner you seem to believe.

When the Commission approves a Settlement, it is issuing a regulatory Order finding the terms of that Settlement, as modified, to be in the public interest. The Commission is a "party" to such a Settlement to the extent that, having approved its terms, courts may find the Settlement terms binding upon the Commission. This situation occurred in the case of the Commission's approved Settlement regarding U S West's disposition of its Yellow Pages assets. The

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Commission approved a Settlement whereby it would forego litigating the transfer of assets while continuing to impose a revenue imputation of \$60 million in future rate cases. Subsequently, the courts found that the Yellow Pages revenue imputation was limited to \$60 million.

However, the Commission is not a Party to the 1999 Settlement in terms of having been a negotiating participant in its development. Nor is the Commission a Party to the 1999 Settlement in terms of being a possible participant in discussions aimed at proposing any amendments to that Settlement. The Commission's authority and obligation is to regulate TEP in a reasonable manner, and to set just and reasonable rates for TEP. Article 15 of the Arizona Constitution establishes those requirements and I'm confident that our current Commissioners will fulfill that obligation.

In any event, in addition to the unwieldy and inappropriate nature of direct participation from Commissioners, their direct involvement in settlement negotiations would require that the entirety of the negotiations be conducted in an Open Meeting. The Open Meeting Law contains no exception that would allow a quorum of Commissioners to participate in negotiations outside an Open Meeting.

The next point upon which I must comment is Mr. Pignatelli's suggestion that negotiations under the 1999 Settlement Agreement would proceed "in parallel" with the Commission's proceedings in Docket No. E-01933-05-0650. Staff is unalterably opposed to any such suggestion. The Commission proceedings are being held at TEP's request; TEP's request is that those proceedings "amend" the Decision approving the 1999 Settlement Agreement; and the proceedings have been accelerated specifically to accommodate TEP's perception that it is important to have them concluded as soon as possible. It is outrageous to propose that some parallel set of settlement talks would occur, presumably involving a subset of the participants in the regulatory proceedings, but at the same time as those proceedings, with the stated objective of "settling" a subset of the issues presented by the proceeding. I cannot fathom that the Commissioners would ever consider adopting any "settlement" that emerged from such a process, let alone participate in it.

I note that the final point made in Mr. Pignatelli's letter to Commissioner Mayes suggests that TEP has been seeking a resolution to what he calls 1999 Settlement issues for several years. As both of you must be aware, the Commission and its Staff have been fully engaged in attempting to resolve the issues that result from the 1999 Settlement for an even longer period of time. The Commission's Track "A" and Track "B" proceedings were explicitly designed to address issues that have emerged from the 1999 Settlement, in light of the *Phelps Dodge* decision. Staff has repeatedly requested that TEP submit a full, cost of service rate case, applicable to all assets that are devoted to public service in Arizona (including TEP's generation assets). The rationale behind that request has been to examine what would constitute just and reasonable rates for TEP as of January 1, 2009, and resolve remaining issues under the 1999 Settlement. TEP has continually resisted making such a filing. Instead, TEP continues to provide the outlines of "proposals" that TEP asserts will resolve those issues.

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When called upon to provide details of the proposals and supporting documentation, TEP's response has been to threaten litigation. Staff is prepared to discuss issues or to litigate the proper rates for TEP. Staff doesn't believe we should be required to do so in a vacuum. Nor does Staff believe we should be required to litigate an undeveloped TEP case at the same time as settlement discussions are ongoing among an incomplete cast of participants. Based on the posture of the regulatory proceeding that TEP has filed, as well as the history of that proceeding,

I believe the most fruitful exercise we could all undertake right now is to conduct the scheduled hearing. If TEP feels otherwise, the first document that should be filed is a Motion to Continue the hearing. In the absence of such a Motion, we will assume that the regulatory proceeding will proceed as scheduled and that the Commission's decisions will dictate future processes.

Sincerely,



Christopher C. Kempley
Chief Counsel, Legal Division

CCK:rbo

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